

***United States Court of Appeals
for the Second Circuit***



**RESPONDENT'S
BRIEF**

76-4236

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 76-4236

F. K. KERPEN & CO., INC., and
FRED K. KERPEN,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Petition for Review of an Order of the
Securities and Exchange Commission

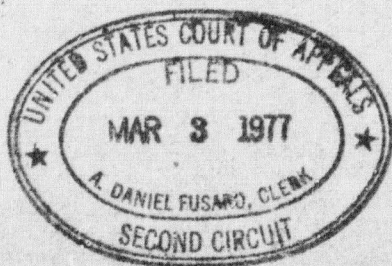
ANSWERING BRIEF OF THE SECURITIES
AND EXCHANGE COMMISSION, RESPONDENT

HARVEY L. PITT
General Counsel

KATHRYN B. McGRATH
Assistant General Counsel

SAMMY S. KNIGHT
Attorney

Securities and Exchange Commission
Washington, D.C. 20549



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COUNTERSTATEMENT OF THE ISSUES

1. Did the Commission abuse its discretion in affirming findings of the National Association of Securities Dealers, Inc. that the petitioners had failed to supervise the activities of a registered representative properly, when there was substantial evidence in the record to show that the petitioners were on notice that the representative had wrongfully converted customers' funds to his own use and that the petitioners had failed to take timely steps to inquire into his activities or to prevent further losses to customers?
2. Did the Commission err in determining that the Association's censure of, and assessment of costs against, both of the petitioners, and the

ten-day suspension imposed upon Mr. Kerpen, for failing properly to supervise the registered representative, were not excessive or oppressive sanctions?

COUNTERSTATEMENT OF THE CASE

Facts

Fred K. Kerpen and F. K. Kerpen and Co., Inc., have petitioned this Court, pursuant to Section 25(a)(1) of the Securities Exchange Act of 1934, 15 U.S.C. 78y(a)(1), to review an order of the Securities and Exchange Commission entered on October 15, 1976 (R. 316) 1/. That order sustained findings by the National Association of Securities Dealers, Inc. ("NASD") that Mr. Kerpen and the firm had failed to supervise a registered representative properly, who, on several occasions, had illegally converted certain customers' funds to his own use. The Commission also affirmed the NASD's censure of Mr. Kerpen and the firm, the ten-day suspension from association with any NASD member imposed against Mr. Kerpen, and the assessment of the costs of the proceedings before the NASD against Mr. Kerpen and the firm. 2/

1/ The NASD's actions were reviewed by the Commission pursuant to Section 19(d) of the Securities Exchange Act of 1934, as amended, 15 U.S.C. 78s(d).

Pages of the record before the Commission are cited as "R. __."

2/ The NASD has stayed the effectiveness of the sanctions imposed against the petitioners pending a determination of the instant appeal by this Court. CCH, NASD MANUAL, 705.

A. The Proceedings Before the NASD

On January 9, 1973, the District Business Conduct Committee for District No. 12 of the NASD filed a complaint (R. 11-14) against F. K. Kerpen & Co., Inc., Fred K. Kerpen, the firm's Registered Principal, and Fabian Nebenzahl, a registered representative employed by the firm, alleging that:

1. Mr. Nebenzahl, during the period from about August 15, 1968, to April 3, 1970, while acting as a registered representative of F. K. Kerpen & Co., Inc., had violated Sections 1, 18 and 19(a) of Article III of the Rules of Fair Practice of the NASD by engaging in a course of conduct which operated to deceive and defraud various public customers in that he, among other things --

a) on four different occasions in 1968 caused to be liquidated \$9,189.50 worth of shares of The Dreyfus Fund, Inc., in the accounts of two customers, Andrew and Tamara Borowiec, took possession of the checks to the customers, and "appended the names of the customers to said checks, negotiated same and appropriated the funds to his own use and purposes, all without the knowledge and consent of said customers" (R. 12);

b) received five separate checks for \$500 each on or about December 2, 1969, January 6, 1970, February 5, 1970, March 8, 1970, and April 3, 1970, from a customer, Sandy Joel Siff, for purposes of investment in The Dreyfus Leverage Fund, Inc., but which Nebenzahl converted to his own personal use without the knowledge or consent of Mr. Siff; and,

c) received two separate checks for \$7,500 each on February 6, 1970, from two customers, Morris and Olga Rutner, for the designated purpose of investment in The Dreyfus Fund, Inc., but which Nebenzahl instead converted to his own use without the consent of the customers.

2. F.K. Kerpen & Co., Inc., acting through its registered principal Fred K. Kerpen, "failed to properly supervise * * * Fabian Nebenzahl," in connection with the above described activities, in violation of Sections 1 and 27 of Article III of the Rules of Fair Practice of the NASD; and

3. Fabian Nebenzahl violated Section 1 of Article III of the Rules of Fair Practice of the NASD by failing to comply with a formal

written request of the NASD that he contact a representative of its staff in connection with an investigation of Nebenzahl's activities.

A hearing on these charges was held before the NASD's District Business Conduct Committee on April 11, 1974. 3/ Mr. Nebenzahl did not appear or otherwise challenge the allegations against him. Mr. Kerpen appeared on behalf of himself and F. K. Kerpen & Co. to contest the Second Cause of Complaint, but did not challenge the First and Third Causes of Complaint which were directed at the activities of Nebenzahl. On May 31, 1974, the Committee issued a written decision 4/ in which it found each of the violations that had been alleged and concluded that

"Mr. Nebenzahl induced the purchase of or caused the liquidation of securities in a manner calculated to defraud customers of their funds or securities [as alleged in the First Cause of Complaint] in violation of Sections 1, 18 and 19(a) of Article III of the [NASD's] Rules of Fair Practice" (R. 164).

The Committee, noting Mr. Kerpen's likely pecuniary incentive in allowing Nebenzahl to conduct himself without instructions, 5/ further found that

3/ The transcript of that hearing appears at R. 25-85.

4/ R. 160-166.

5/ The Committee noted that

"Mr. Kerpen seemed to have been awed by the selling talents of his registered representative [Nebenzahl], a man Mr. Kerpen described as an extraordinary salesman who could persuade his clients to draw checks payable to him. Perhaps this admiration, coupled with the sluggish, unencouraging character of the marketplace, caused Mr. Kerpen to 'look the other way' in the hope that his salesman and the market would improve" (R. 165).

See also, R. 18.

"Mr. Kerpen was lax and negligent in the performance of his duty to supervise Mr. Nebenzahl, whose illicit activities caused several customers to suffer a financial loss" (R. 165). The Committee thus permanently barred Nebenzahl from association with any member of the NASD in any capacity, fined him \$25,000 and assessed him costs of \$99. The petitioners in this proceeding, Mr. Kerpen and F. K. Kerpen & Co., Inc., were censured and assessed costs of \$99. 6/

Mr. Kerpen and the firm appealed the District Business Conduct Committee's decision to the Board of Governors of the NASD. 7/ After a hearing, 8/ the Board affirmed the Committee's findings, but altered the sanctions imposed on Mr. Kerpen and the firm to a censure, and imposed a ten-day suspension on Mr. Kerpen. 9/

6/ Mr. Kerpen and the firm also were initially ordered to follow certain administrative procedures and prepare certain reports concerning supervision and hiring of sales personnel, and the handling of customer complaints (R. 165). But this portion of the order was not affirmed by the Board of Governors of the NASD on appeal. See n. 9, infra.

7/ Nebenzahl did not appeal the District Business Conduct Committee's decision.

8/ The transcript of the proceedings before the NASD's Board of Governors appears at R. 184-220.

9/ R. 232-233. Mr. Kerpen and the firm were also assessed the costs of the appeal in the amount of \$262.41.

The administration and reporting requirements imposed by the Committee were eliminated as being superfluous, "since they are obligations imposed upon both [Mr. Kerpen and the firm] by virtue of their registrations with the Association" (R. 233).

B. The Commission's Opinion

Mr. Kerpen and the firm applied to the Commission to review the NASD's action, 10/ but explicitly waived any opportunity to present oral argument. 11/ After consideration of the record before the NASD and the briefs and statements filed by the parties, the Commission sustained the findings and sanctions imposed by the NASD. The Commission noted that the NASD's findings concerning Nebenzahl's misconduct were not disputed, and agreed with the NASD's conclusions that Mr. Kerpen

"had reason to believe, at least as early as February 1970, that Nebenzahl had converted a customer's monies

10/ Nebenzahl did not seek Commission review of the NASD's findings and sanctions against him.

11/ In a letter, dated June 8, 1975, to Mr. George A. Fitzsimmons, Secretary of the Securities and Exchange Commission, Mr. Kerpen wrote

"Aware of the procedure for obtaining oral argument before the Commission, I do not feel that I could add substantially by appearing in person, having put everything I can think off [sic] in writing. Should the Commission, however, wish to gain a personal impression, I'll be glad to appear in Washington" (R. 287).

The Commission's Rules of Practice provide that oral argument may be requested by the applicant "within 10 days after receipt of the association's answer, or if no such answer is filed, within 30 days after the date on which the applicant filed his brief or statement." Rule 15Ag-1(f), 17 CFR 201.15Ag-1(f). The brief on behalf of the NASD was filed on June 3, 1975 (R. 294). Over a year later, on August 9, 1976, well past the deadline for a timely request and well after the submission of the above-described waiver of oral argument, Mr. Kerpen wrote another letter to Mr. Fitzsimmons and therein, for the first time, requested an opportunity for oral argument (R. 309). Mr. Fitzsimmons, in a letter dated August 19, 1976, informed Mr. Kerpen that "[t]he briefing and argument times have passed and the case is under consideration by the Commission." Mr. Kerpen's request was, therefore, denied (R. 310).

intended for investment. This customer instituted legal action resulting in a judgment against Nebenzahl on October 10, 1970. Kerpen was served with an attachment in connection with that case, although the attachment was released shortly thereafter when the customer apparently agreed to accept Nebenzahl's promise of restitution.

The NASD reasoned that these events, coupled with the fact that Kerpen had earlier received a copy of a complaint from one of Nebenzahl's customers to the Dreyfus Fund concerning unauthorized liquidations of his and his wife's accounts, should have prompted Kerpen to investigate thoroughly Nebenzahl's accounts and activities" (R. 313).

The Commission further noted that Nebenzahl's employment with F. K. Kerpen & Co., Inc., was not terminated until September, 1971, even though Mr. Kerpen and the firm had reason to believe, at least as early as February, 1970, that Nebenzahl had wrongfully converted customers' monies. The Commission concurred in the NASD's finding that "Kerpen should have acted sooner" (R. 313).

Mr. Kerpen argued that, since Nebenzahl attempted to make partial restitution to the customers involved, Mr. Kerpen "felt at the time that he should attempt to rehabilitate Nebenzahl, rather than deal harshly with him" (R. 313); the Commission, however, was

"* * * not persuaded by such reasoning, particularly in view of the clear responsibility for supervision which long has been imposed upon broker-dealers and persons controlling them. Even assuming, arguendo, that Kerpen was justified in not terminating Nebenzahl's employment with the firm immediately when it became clear that at least one customer's funds had been converted, Kerpen at the very least should have examined thoroughly all of Nebenzahl's accounts, especially the one which had been the subject of the earlier complaint to the Dreyfus Fund. Accordingly, we affirm the NASD's findings of violation" (R. 314)(footnote omitted).

Based upon the foregoing, the Commission stated that it was "unable to conclude that the sanctions imposed on applicants are excessive or oppressive" (R. 314-315) and thus affirmed the action taken by the NASD.

ARGUMENT

- I. THE COMMISSION'S FINDINGS THAT THE PETITIONERS FAILED PROPERLY TO SUPERVISE FABIAN NEBENZAHL ARE SUPPORTED BY SUBSTANTIAL EVIDENCE AND ARE, THEREFORE, CONCLUSIVE.

Section 25(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78y(a), pursuant to which the petitioners seek review of the Commission's order, provides that "[t]he findings of the Commission as to the facts, if supported by substantial evidence, are conclusive." ^{12/} Substantial evidence in a Commission proceeding has been held to be "'such relevant evidence as a reasonable mind might accept as adequate to support a conclusion.'" Archer v. Securities and Exchange Commission, 133 F. 2d 795, 799 (C.A. 8), certiorari denied, 319 U.S. 767 (1943), quoting Consolidated Edison Co. v. NLRB, 305 U.S. 197, 229 (1938). See Universal Camera Corp. v. NLRB, 340 U.S. 474 (1951); Federal Communications Commission v. WOKO, Inc., 329 U.S. 223, 229 (1946); NLRB v. Link-Belt Co., 311 U.S. 584 (1941); United States v. Seaboard Surety Co., 339 F. 2d 1 (C.A. 2, 1964); United States v. Handen Co-operative Creamery Co., 297 F. 2d 130 (C.A. 2, 1961). As this Court has held, the factual findings of the Commission are not to be disturbed unless they are clearly erroneous. New York Trust Co. v. Securities and Exchange Commission, 131 F. 2d 274 (C.A. 2, 1942), certiorari denied, 318 U.S. 786 (1943).

The petitioners do not contest that Nebenzahl, their registered representative, committed the repeated misappropriations and forgeries alleged --

^{12/} Section 25(a)(4) of the Securities Exchange Act of 1934, as amended, 15 U.S.C. 78y(a)(4).

misconduct which reoccurred periodically for almost two years -- from August 15, 1968 to April 3, 1970. Nor does Mr. Kerpen dispute the Commission's findings that he had reason to believe, at least as early as February, 1970, that Nebenzahl had converted customers' monies. And, it is not disputed that a judgment was rendered against Nebenzahl in October, 1970, for misappropriation of a customer's funds or that a subsequent attachment against commissions owed to Nebenzahl by F. K. Kerpen & Co., was served on Mr. Kerpen. Nonetheless, Nebenzahl was permitted to remain with the firm until September, 1971, some time after Mr. Kerpen was advised that additional customers had been victimized by Nebenzahl's similar activities (R. 199-204). 13/

Petitioners argue, however, that they were guilty only of "leniency" in trying to "salvage a human being" (Br. 2; R. 208, 218). We are, of course, sympathetic to their concerns. But, the petitioners' "leniency" was bestowed at the expense of their customers to whom they owed a heavy fiduciary duty. And, whatever value there may have been in leniency, if any, toward minor transgressions, "leniency" cannot, and does not excuse Mr. Kerpen's failure to review Nebenzahl's handling of customers' accounts after Mr. Kerpen was

13/ Nor does Mr. Kerpen dispute that he received a complaint in 1969 that Mr. Nebenzahl had forged certain signatures to liquidate customers' shares and convert those funds to his own use. Although Mr. Kerpen explained his failure to investigate this complaint further on the basis of a telephone call and a letter from The Dreyfus Fund, Inc. to the effect that the Fund would investigate the matter (R. 18, 224), Mr. Kerpen does not satisfactorily explain why he did not further investigate the matter when additional complaints were filed against Nebenzahl. A simple follow-up telephone call to the complaining customers presumably would have disclosed that Nebenzahl had written a letter (R. 136) admitting his crime and begging to be given another chance.

placed on notice of Nebenzahl's propensity to misappropriate customers' funds. As the Commission has stated in other contexts, "[t]he maintenance of adequate supervisory controls over salesmen's activities is a basic and vital responsibility of the broker-dealer." 14/ Yet, Mr. Kerpen did nothing either to inquire into Nebenzahl's activities or to take corrective action for more than a year-and-a-half, when he finally asked Nebenzahl to resign following complaints from additional customers (R. 199-204). 15/ Indeed, the petitioners should have taken prompt and effective steps to prevent Nebenzahl's repeated acts of forgery and conversion, as they were required by law to do, if they were intent upon "salvag[ing] a human being."

II. THE COMMISSION PROPERLY UPHELD THE SANCTIONS IMPOSED BY THE NASD.

This Court has stated that "it is important to remember that the Commission is charged with the duty of enforcing the statute in the 'public interest,' a mandate which necessarily 'gives the Commission broad discretion.'"

14/ L.B. Securities Corp., 42 S.E.C. 885, 888 (1966).

15/ R. 65.

Mr. Kerpen suggests (Br. 2) that the Commission's opinion inaccurately relates that he dismissed Nebenzahl only after receiving complaints from three customers. The Commission's opinion, however, simply reflects the evidence which Mr. Kerpen presented to the Board of Governors -- that he permitted Nebenzahl to resign in September, 1971 only after receiving complaints about Nebenzahl's activities from three customers, Morris and Olga Rutner and Mr. Siff. Indeed, a copy of the letter which Mr. Siff submitted to the NASD, found in Mr. Kerpen's files, indicates that Nebenzahl's employment was terminated only after Mr. Siff had filed a formal complaint with the NASD (R. 86, 199, 203, 204).

Berko v. Securities and Exchange Commission, 316 F. 2d 137, 141 (C.A.

2, 1963). 16/ And the Supreme Court has emphasized that, "where Congress has entrusted an administrative agency with the responsibility of selecting the means of achieving the statutory policy 'the relation of remedy to policy is peculiarly a matter for administrative competence.'" American Power & Light Co. v. Securities and Exchange Commission, 329 U.S. 90, 112 (1946). 17/

Having determined that Mr. Kerpen and the firm committed the violations found by the NASD, the Commission could not modify the NASD's sanctions unless, "having due regard for the public interest and the protection of investors", the Commission found that the sanctions imposed a "burden on competition not necessary or appropriate in furtherance of the purposes of * * * [the Securities Exchange Act of 1934 or that the sanctions were] excessive or oppressive * * *." 18/ No suggestion has even been raised by the petitioners that the sanctions entered imposed any "burden on competition," and no basis was established to suggest that the Commission abused its discretion in determining that neither the censure nor the ten-day suspension imposed by the NASD was "excessive or oppressive." Indeed, in light of the harm to customers which resulted from the petitioners' failure properly to supervise Nebenzahl, and the serious nature of Nebenzahl's misconduct which the petitioners failed

16/ See also 2 Loss, Securities Regulation 1323 (2d ed., 1961).

17/ Accord, Butz v. Glover Livestock Commission Co. 411 U.S. 182 (1973); Federal Communications Commission v. WOKO, Inc. 329 U.S. 223 (1946); Hanly v. Securities and Exchange Commission, 415 F. 2d 589, 598 (C.A. 2, 1969); Marketlines, Inc. v. Securities and Exchange Commission, 384 F. 2d 264 (C.A. 2, 1967), certiorari denied, 390 U.S. 947 (1968); Tager v. Securities and Exchange Commission 344 F. 2d 5 (C.A. 2, 1965).

18/ Section 19(e)(2) of the Securities Exchange Act of 1934, as amended, 15 U.S.C. 78s(e)(2).

timely to prevent or rectify, the sanctions imposed upon the petitioners by the NASD, and affirmed by the Commission, were minimal, and cannot be said to be an abuse of discretion, much less "too severe." 19/ Cf. Arthur Lipper Corp. v. Securities and Exchange Commission, ___ F. 2d ___, CCH Fed. Sec. ¶95,796 (C.A. 2, Dec. 10, 1976), petition for rehearing pending.

In this connection, it should be noted that sanctions imposed against broker-dealers "are intended to be remedial rather than penal, a result of the fact that the 'design of the statute is to protect investors' and the general public in this specialized field." Berko v. Securities and Exchange Commission, supra, at 141, quoting Securities and Exchange Commission v. Ralston Purina Co., 346 U.S. 119, 124 (1953). 20/ In its opinion in the

19/ The remedial sanctions available to the NASD for a violation of its rules include censure, the assessment of the costs of disciplinary proceedings, the imposition of a fine "not in excess of Five Thousand Dollars (\$5,000) * * * for each or any violation," suspension or expulsion from the association and "any other fitting penalty deemed appropriate under the circumstances * * *." Article V, Section 1, NASD Rules of Fair Practice. In contrast to its mild treatment of the petitioners, the NASD permanently barred Nebenzahl from association with any member of the NASD, fined him \$25,000, and assessed the costs of the proceedings against him in the amount of \$99 (R. 166).

The petitioners also complain that no action was taken against The Dreyfus Fund, Inc. (Br. 1,2). However, the NASD had no jurisdiction to initiate disciplinary proceedings against The Dreyfus Fund, Inc., since that Fund is not a member of the NASD. CCH, NASD Manual, 452.

20/ See also Pierce v. Securities and Exchange Commission, 239 F. 2d 160, 163 (C.A. 9, 1956); accord, Associated Securities Corp. v. Securities and Exchange Commission, 293 F. 2d 738, 741 (C.A. 10, 1961):

"The balancing of private detriment against public harm requires the fair and proper exercise by the Commission of its discretionary powers. The evaluation of facts and the exercise of judgment for the protection of investors dealing in over-the-counter securities is a function assigned by Congress to the Commission rather than the courts and, the exercise by the Commission of its discretionary powers will not be upset by the courts except for cogent reasons."

instant case, the Commission acknowledged this responsibility by stating

"[W]e are mindful that impressing upon applicants the importance of their obligations is only one of the purposes of imposing sanctions. The sanctions in this case are also intended to illustrate to other persons the commendable seriousness with which the NASD regards a failure to supervise properly, a concern fully shared by this Commission. Under the circumstances, we are unable to conclude that the sanctions imposed on applicants are excessive or oppressive" (R. 314-315).

CONCLUSION

For the foregoing reasons, the order of the Commission upholding the decision of the NASD should be affirmed.

Respectfully submitted,

HARVEY L. PITT
General Counsel

KATHRYN B. McGRATH
Assistant General Counsel

SAMMY S. KNIGHT
Attorney

Securities and Exchange Commission
Washington, D.C. 20549

March, 1977

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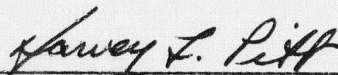
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No. 76-4236

CERTIFICATE OF SERVICE

I hereby certify that on this 3rd day of March, 1977, I caused
copies of the foregoing ANSWERING BRIEF OF THE SECURITIES AND EXCHANGE
COMMISSION to be mailed, postage prepaid, to the following individual:

Mr. Fred K. Kerpen
F. K. Kerpen & Co., Inc.,
27 Washington Square North
New York, New York 10011



HARVEY V. PITT
General Counsel

Securities and Exchange Commission
Washington, D.C. 20549